RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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May 2, 1984 *LETTER 886*

April 19, DJIA 1158.09; PTI 1664; A-D ratio –19.11
April 27, DJIA 1169.07; PTI 1660; A-D ratio –18.97

THE MARKETS: Despite what you may hear, it's getting harder to make money in the US. Fortune magazine (April 30) reported on the 500 largest corporations in the nation. The recovery from the 1982 recession has been very lop-sided with autos leading the recovery. But sixty of the 500 lost money last year, a record.

As far as the markets are concerned, they may be subtly reflecting this deterioration. Contra-Signals of Hingham, Massachusetts keeps careful tabulations of stocks and stock groups from a relative strength standpoint. In the latest issue Contra-Signals reports that their trend reversal count is "heavily negative, setting an all-time high for *downward* signals during three consecutive months." Translation—a lot of stocks are now giving bearish signals, the most in a three-month period in Contra-Signals' long history!

The short interest jumped 10% on the NYSE and the short interest ratio climbed to 2.27. But sadly, I am removing the short figures from my list of market tools. There is so much arbitrage and tricky positioning in the short area that I simply don't trust the figures any longer.

To my mind, the most important statistic on Wall Street today is the bond/stock ratio. The yield on the Dow is currently 4.8%. This is, of course, a taxable yield. The non-taxable yield on AA-rated general obligation municipal bonds is roughly 9.7%. Thus, we have the fantastic case of non-taxable bonds yielding twice what the taxable income is on the Dow. Under these circumstances, the investor or portfolio manager faces a staggering problem. The problem is—"How do I justify the purchase or retention of common stocks?" The answer must come from one of three concepts: (1) Stock earnings and dividends are ready to roar into the wild blue yonder. (2) Bond prices are about to explode, thereby collapsing bond yields and rendering stock yields attractive. (3) We are moving into an area of hyper-inflation, and only real assets and stocks will weather the storm.

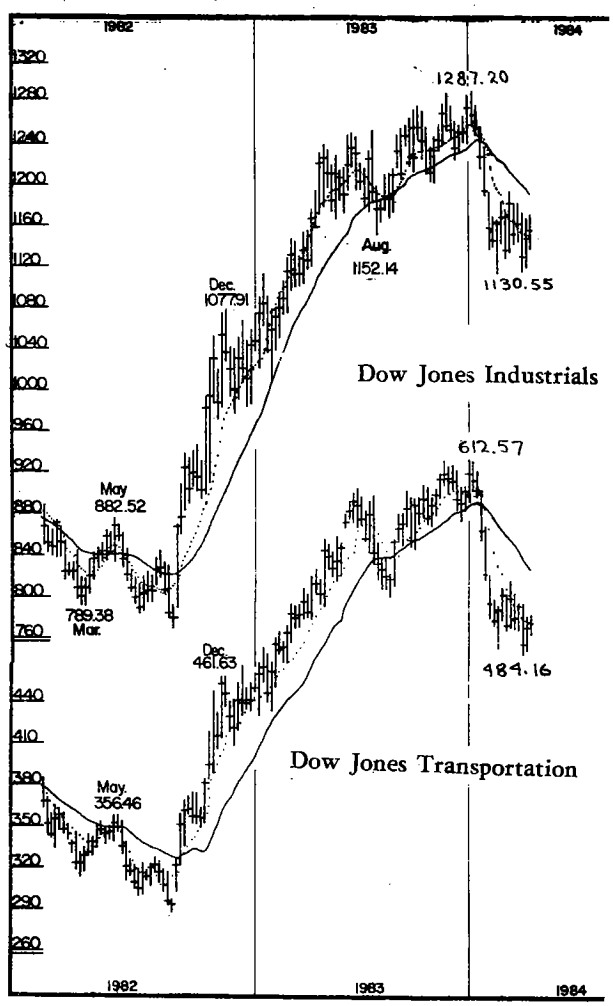
This writer is profoundly skeptical of numbers 1 and 2 and fairly skeptical of number 3. If I'm correct, then the stock market today is at best a trading affair; in other words, a trading buy on oversold situations. But longer term Dow's most basic of principles should overwhelm all other arguments. That principle states that "To know VALUES is to know the meaning of the market." The stock/bond ratio says that stocks are ridiculously expensive compared with bonds.

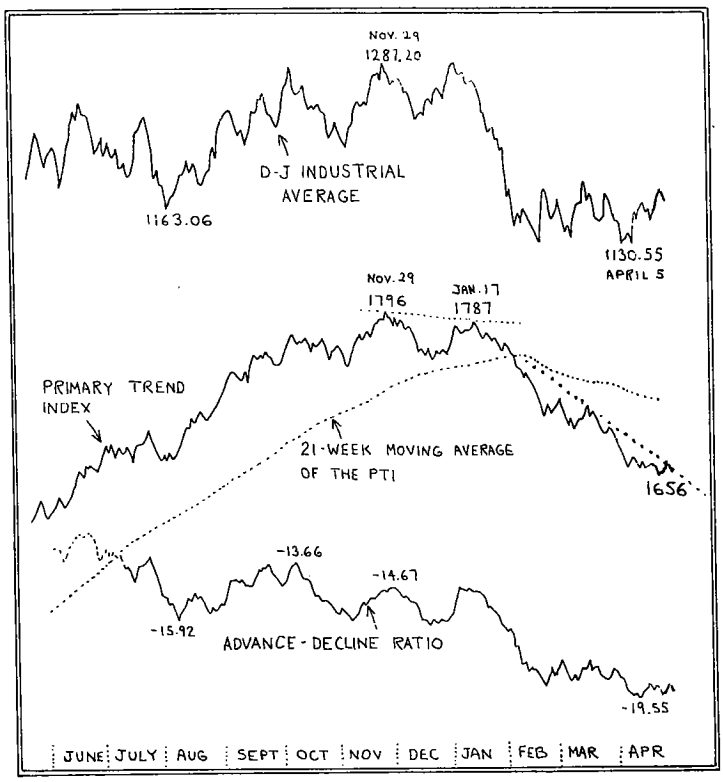
The advisory services and newspapers are swarming with opinions regarding "what the market is going to do next." Studies abound on breadth/momentum, put/call ratios, specialist short indices and what not. As usual, I prefer to work with the actual price movement along with breadth indices (which are actually closely connected with the price movement).

From the near-term standpoint, there are a number of plus factors in this stock market. Here they are, as I see them. (1) As of the week ending April 15, my PTI was down (on a Friday basis) on 12 of the previous 15 weeks or 80% of the time. That's just too much downside action, and the PTI should now start correcting to the upside.

(2) On the breaking of the February lows by the D-J Industrial and Transportation Averages during April, the big composite average *did not confirm* on the downside. In fact, even when the advance-decline ratio (see page 2 chart) broke to a new 1984 low, the NYSE Composite and the Standard & Poor's 500 Stock Index refused to violate their February lows. This was a sign of stubborn downside resistance.

(3) On April 26 my cumulative most-active stock index rose to a new 1984 high. This is impressive and indicates that there has been quite a bit of accumulation over the last month.





(4) On April 26 (chart above) the PTI barely nudged above its current bearish trendline, a trendline that extends down from the January 17 peak. On April 27 the PTI fell back again—but it is pushing against that trendline.

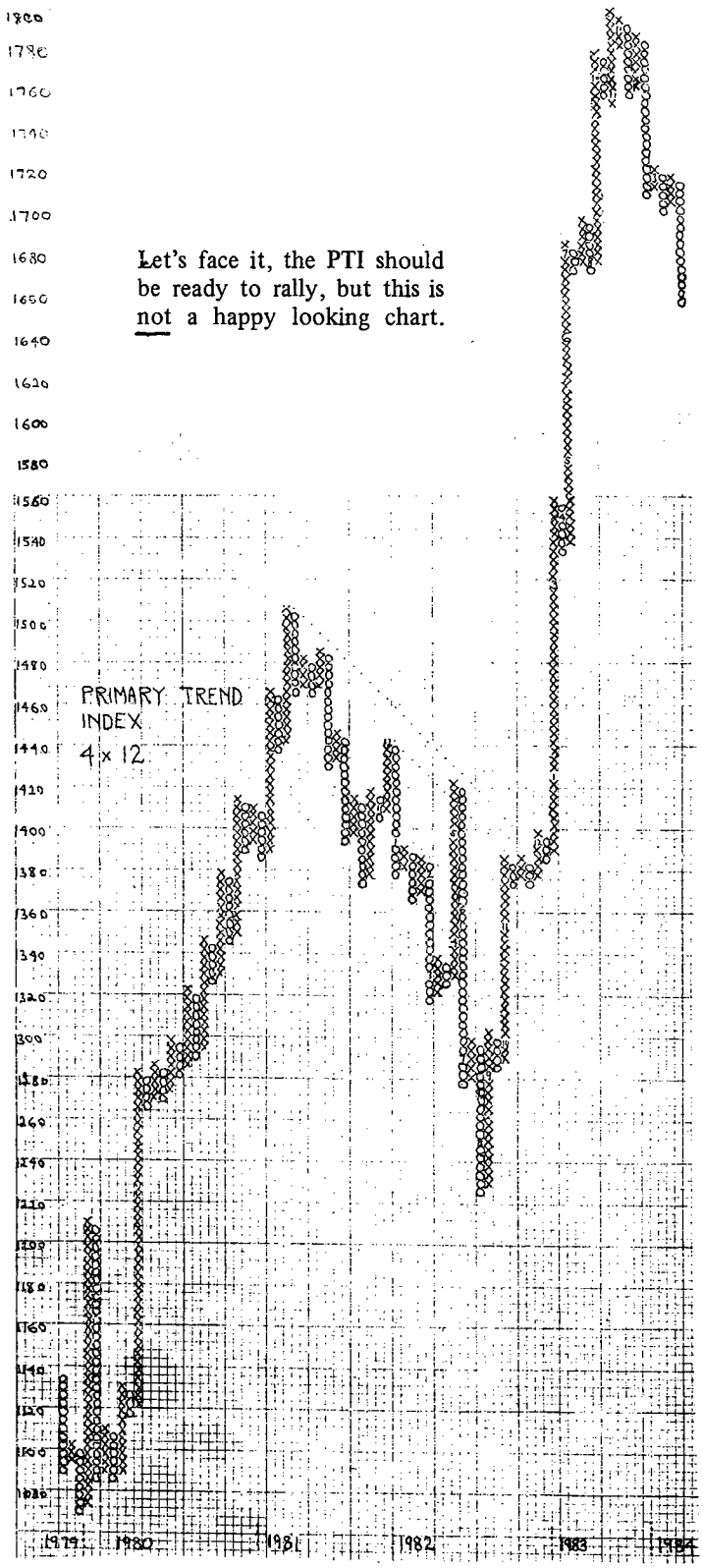
(5) Since late-February the A-D ratio (page 2 chart) has been losing downside momentum. The majority of stocks, as measured by this index, are tired of going down.

(6) Here's a most interesting item. On February 23 the D-J Utility Average struck a 1983 low of 123.70. That low (despite all the adverse nuclear reactor news) has not been violated. And remember, the utilities are very interest-rate sensitive, and interest rates have been going up since Febaruy 23. So the Utility Average, which often acts as a bellwether for the rest of the market, has refused to crack its February low. This action, like the action of the NYSE and S & P Composites, is positive for the market.

Now here is an important item from the Dow Theory standpoint. Following the February 22 lows in the D-J Averages, the Industrials and Transports rallied to March closing highs of 1184.36 and 520.58 respectively. These are important benchmarks on the upside. Industrials are now near their March highs, but Transports have a way to go. If this rally continues, it will be most important to note whether BOTH the Industrial and Transportation Average can better their March highs. If they do, I would expect to see an important and maybe powerful push back to the highs (with by far the biggest gains being made in the blue-chip issues and expecially the oils).

Question: Is this still a bear market? How do you see it?

Answer: We received a primary bear signal in February, and that bear signal was re-confirmed in April. Thus, from a Dow Theory standpoint a bear market is in progress. Under Dow Theory, we see that a trend continues until proved otherwise.



The 21-week moving average of the PTI (see top left chart) now stands at 1711. The daily PTI is currently a whopping 50 points below the moving average. Normally, this would call for holding action or a rally since the PTI is so far below its moving average. But this is a tricky market, and I want to see if the PTI can push decisively above the bearish trendline—or whether it is just teasing us preparatory to dropping to new lows.

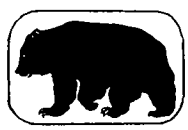
Comment: In thirty years of watching and studying markets, I have developed a few good instincts. A good market instinct ("market horse sense") can often save you a lot of grief.

I've noted over the years when too many people play the same game, then for some reason the game ends. I've seen the game end for steel stocks, for energy stocks, for science stocks, for gambling stocks, for penny stocks, for collectibles, for—well you name it.

One thing that makes me a bit uneasy is the current widespread love affair with no-load switch funds. Yes, I know that I recommended switch funds, and yes, I know that I espoused no-load funds. But at this point every magazine and newspaper has been either touting or running adds for switch funds. A number of market services are currently concerned only with timing switch funds. So I'm beginning to "turn off" on this concept.

What would "kill" the public's love affair with switch funds? Easy, a frustrating, whipsawing market, and that's what we could have over the foreseeable future. We could see an extended period where the market provides switches back and forth (money market funds to stock funds and back), a market in which each switch costs the switcher 5% or 10%. Add three or four of such switches and you've lost maybe a third of your capital.

INVESTMENT POSITION: The PTI has pushed just above its declining trendline, and bold traders could probably take positions here. On the bigger picture for the PTI (see P & F chart) a rally in the PTI would simply build a right shoulder on what appears to be a huge head-and-shoulders top. Thus, it is hard for me to be wildly enthusiastic about this market.

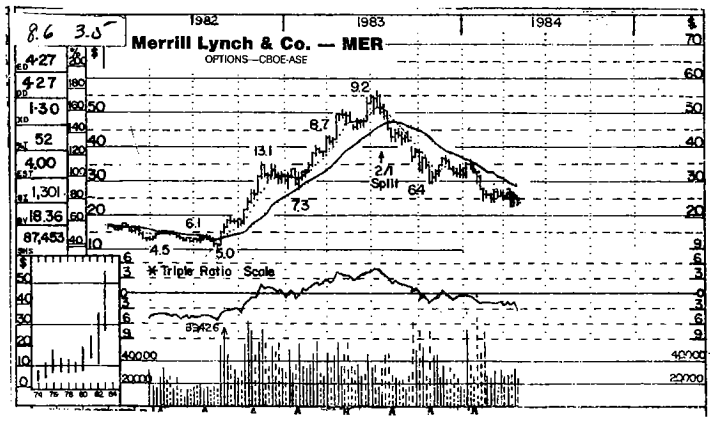


The position of being in cash, T-bonds, T-notes, or money market funds suits me fine, and it is one that I recommend to most of my subscribers. I have a feeling that this is going to be a frustrating year of whipsaws, even though some see a boom ahead and a few (like Granville) see a crash.

The bond market looks exhausted on the downside, and it may confound many by holding or even rallying. The dollar may continue to surprise with its strength and gold may surprise by not making money for holders. All in all, I expect a frustrating year for those who hold anything but interest bearing money instruments.

Think you can make it in commodity futures? Just check the record of the professionally managed funds.Three-quarters of them lost money in 1983 and in 1984 so far. Please don't worry about 'em, they make it on commissions regardless of whether the funds make or lose money. But you and I, when we lose on a commodity contract we lose both assets and commissions. By the way, did you ever hear of a brokerage office manager who asked his brokers how the customers are doing?

WALL STREET: "Where coming events cast their shadows before, those shadows fall on the New York Stock Exchange." (W.P. Hamilton, 1925). Readers can probably sense that I'm not terribly enthusiastic about the US economic picture for the foreseeable future. I have contacts with brokers all over the Nation, and I can tell you that they are now hurting. Wall Street



is taking a beating today, partly because business is lousy and partly because the brokerage houses (as usual) over-expanded.

Merrill Lynch is the biggest thing on Wall Street, and recently Merrill's earnings have collapsed—as has their stock (along with Hutton, Paine Webber, and American Express). This chart shows the story, and here we see MER losing roughly 60% of its market value. What worries me is Hamilton's observation. When trouble comes, it hits Wall Street first. And I can tell you, the trouble is now hitting the Street (chart courtesy of Mansfield, 2973 Kennedy Blvd., Jersey City NJ 07306).

MUNIS-BONDS: I have been besieged by letters about municipal bonds since the mailing of Letter 884. Lots of questions.

Question: What about insured bonds, many of which are rated AAA?

Answer: I am not hot on insured muni bonds. I always ask the question, "If they are so good why do they have to be insured?" That may not be completely fair, but I prefer bonds that stand on an AA or AAA rating on their own.

Question: How liquid are municipal bonds?

Answer: Some are, many ain't. For real liquidity, I like the AA or AAA state bonds, and these bonds are always GO or general obligation bonds. That means that they are backed by the full faith or credit of the given state. Of course, there are many very good city and county bonds, but obviously a Houston bond (rated AAA) is going to be a lot more liquid than a bond from Lackawanna, NY (rated B).

Question: Do you like revenue bonds?

Answer: In general, I'd prefer GOs to revenues. The revenue bonds depend on the revenue from a certain enterprise. Some enterprises are great, others are questionable. For instance, the Los Angeles Dept. of Water and Power are fine bonds, and I own some. But other lesser situated revenue bonds are not for the faint of heart. My own feeling for most of my subscribers is why guess—stay with state GOs. If your state goes bankrupt, you'll have so many other worries you won't mind if they refinance your munis!

Question: How far out should I go on maturities?

Answer: I'd go out as much as 10 years. But buy them over a 12 month period of time. Average out your purchases. Don't

plunk down all your cash at once.

Question: How about my bonds being called?

Answer: Easy, check and see if your bond has a call provision before you buy it. Many bonds can be called, and they might be if interest rates drop and the state or city wants to refinance at lower rates. Obviously, I prefer a non-callable provision, but many callable bonds are so attractive that they are worth the risk of a call.

Question: Why are you writing about munis now?

Answer: A number of reasons. (1) I think we are seeing NOW the lowest taxes we are going to see in our lifetime. Taxes are going UP. (2) As taxes go up, munis are worth more since they escape taxes. (3) The IRS is going to close a lot of tax shelters and loopholes. That makes munis one of the last hiding places.

Question: Couldn't the government make the munis taxable?

Answer: The government can pass a law saying that an asparagus is a pretzel. The government can do anything it wants to. But I don't think the government will outlaw munis, because the states and the cities and the counties need to raise money, and the muni path is the only way they can compete successfully. Even if the government wanted to shut down the muni tax free aspect, I am convinced they would "grandfather" the bonds that have already been issued. To do otherwise would create a deafening uproar from big money interests (banks, institutions, influential investors, and from the Congress itself–don't forget, Congressmen and Senators represent states that need money).

Question; What do you think of the zero based bonds?

Answer: These bonds are offered by Merrill Lynch, Lehman, Hutton, Prudential Bache, Becker, and others. They are Treasury bonds that have been stripped of all interest bearing coupons. The brokerage house then sells the principal certificate or its receipt to the customer–and the principal, of course, is sold below face value. You receive a lump sum when the bond matures (but you pay a tax each year just as though you received the interest). These stripped bonds are a good deal for pensions or IRAs. My single objection is a personal one–I like that interest money coming in every six months on ordinary bonds or munis. I feel restricted with zero-based bonds, but you can always sell the bond if you get impatient or unhappy. The bonds also eliminate the problem of reinvesting, since you will know exactly your return based on price and years to maturity.

Question: What about the muni unit trusts and the no-load muni funds?

Answer: They both have a plus in that they are liquid, since the issuers will buy them back. But in the case of unit trusts you pay a commission, often as high as 8%. With the no loads yields are sacrificed because of the management costs which are factored into the return. Personally, my own feeling is that I would rather buy the direct obligation, and get the full yield. If you stick to the general obligation bonds of your own state I think you are going to be pretty safe.

THOUGHTS: The predictions of the dollar's collapse have reached a deafening roar. Every analyst and his brother now advocates selling the dollar (i.e., buying a foreign currency). Can this many people call the top on anything? Maybe, but they might go broke first, because calling the top in the currency markets is a matter of pin-point timing and huge risks.

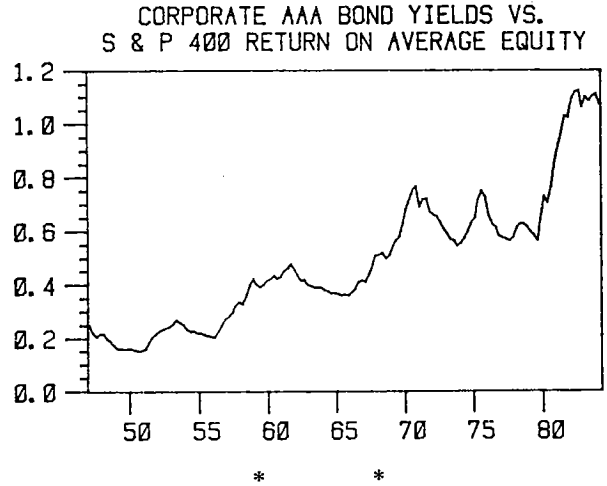
There are two supreme gauges in investing. (1) Values, and (2) the trend of those values. Right now many important stocks (including many Dow stocks) are selling at below 10 times earning (some below 8 times earnings). Thus, from a historical basis, many blue chips are reasonably priced. If bond yields were low (which, of course, they aren't) and bond yields weren't so much more attractive than stock yields, there is no doubt in my mind that the stock market would take off.

As far as the trend of stocks, it is still down according to my studies. Furthermore, with the trend of the Bank Credit Analyst's debit/loan ratio bearish, the odds are that corporate profits are going to *contract* during the second half of 1984.

Thus, the stock market at best could be in a wide trading range with a floor at say the 1100 range, that floor based on the fact that many good stocks represent values here. On the other hand, I feel that current high bond yields also have put a ceiling on stock prices.

This chart states the problem rather dramatically. Back in 1949-50 the yield on AAA bonds was about 20% of the return on average common stock equity. Currently, the yield on AAA is actually higher than the return on average stock equity. Under these conditions, the stock buyers have to be asking "Where's the beef?"

In such an atmosphere, money will consciously or unconsciously move towards the area of greatest return. This area is the money markets, and here you can take your choice of bonds, notes, bills, munis, C/D's, etc.



In talking with Melvyn Lippman of US Organization Chart Service, La Jolla, we both agreed that the draft is coming back. Reason: the US cannot compete with Russia in the military when Russia pays its soldiers $10 per month and the US pays near $600 per month.

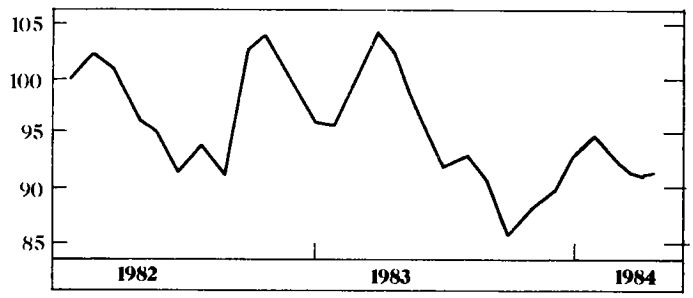
The defense budget is now roughly $240 billion. A whopping 60% of this goes to salaries. If the draft was instituted, it would probably save the Nation $70 to $80 billion a year. Conclusion: the draft is coming–it's just a matter of time.

Doomsday: A lot of people believe that the US is going on to ever bigger and better things. And a lot of other people believe that doomsday is just over the next hill. Whether you believe in the first or the second concept, it's nice to have a chart to tell you whether things are getting better or "less better."

My friend Jim Grant (Grant's Interest Rate Observer, 233 B'way, NYC 10279), a former Barron's columnist, has come out with a "train wreck" index in his excellent newsletter. Grant's Bank Audit Index is based on two ratios, a ratio of NYC banks to the S & P 500, and a ratio of T-bills to bank C/Ds. The concept is simple and fundamental enough. The nearer the big NYC banks get to Armageddon, the worse the stocks will act vs. the broad market and the worse their C/Ds will act vs. the T-bills.

Note on the chart the index hit its low in late-1983, and not in the summer of '82 when rumor had it that Mexico was bankrupt. The index rebounded into early 1984, and it has been sliding just a bit since. The economic health of the nation may well depend on the index's ability to hold above the 1983 low. Time will tell, and I will keep my subscribers apprised of this index.

Grant's Bank Audit Index ©



NOTICE: I think it was about 15 years ago that I published chart books of the D-J Averages. The books included a three-hole punched page for each year of the Averages from 1885 to the present. The book contained the daily D-J Industrials, Transports, Utilities, Bonds and daily volume, together with notations on important events of the year. I printed 1500 copies of these chart books, and they sold out quickly.

At the same time I published daily charts of the Dow and the advance-decline line with a page for each year from 1930 to the present. Both chart books have been up-dated annually to the present, and this process will continue.

I have received numerous requests for these volumes, but obviously I could not supply them since they were sold out years ago. Now, however, I can supply Xerox copies of the volumes collated in three-ring binders. The Xerox pages are not as clean and sharp as the original printed pages, but they are quite good. If subscribers want a copy of either the D-J Averages or the Dow and the A-D ratio the price is $120 for the D-J Average volume and $90 for the A-D album. To my knowledge, there is nothing else like these albums being offered. They are collectors pieces as well as valuable study books (price includes postage or UPS). Make checks out to Richard Russell please.

QUOTES THAT DESERVE REPEATING: From a recent issue of the Washington Post, article on narcotics: "Cocaine is God's way of telling you that you have too much money."

From Francis Kelly (Oppenheimer & Co.): "At heart, bond investing is a test of confidence in government's management ability; stocks, a test of the private sector adaption to government's mismanagement."

NOTES: The Russian propaganda onslaught against the Olympics continues. The latest from a leading Soviet newspaper alleges that a LA group plans to kidnap Russia's top Olympic athletes and coaches. The reason behind the Russian hysteria is clear (at least to me). Russia is afraid of defections to the US and is frightened by the prospect of some of its star athletes seeking asylum. Thus, the Russian cries of "kidnapping plot." If and when the defections occur, Russia will accuse the US of criminal abductions or brain washing or luring its athletes away. I believe these fears are so great on the part of the Russians that they are almost willing to forego the Olympics.

* *

Tired of being an optimist? Then glance over this piece from Financial World (May 2). Seriously, I've known Joe G. for 22 years, and when he's hot, he can be the hottest analyst in the business. Like me and every other guy in this business, Joe has been wrong, but I've learned never to write him off. I developed a thesis years ago in this business, and it runs like this. "Watch the bright analyst who's been right for a long period of time. He's just around the corner from being dead wrong. Watch the bright analyst who's been wrong for a long time. He's just about to be very right."

There is only one precedent to the economic slump that Granville has forecast, and he is quick to point it out: "I now have 333 exact parallels with 1929," he says, citing a list of 13 specific indicators that signal the beginning of a market decline. They are: (1) a huge new-issue market in 1983 which went sour; (2) a rise in the prices of "low-priced" stocks; (3) a record number of stock splits; (4) a big resurgence of public interest in mutual funds; (5) increased pension fund investment in stocks (65% of their portfolios, on average); (6) a record number of new brokers (48,000 since 1982); (7) a record number of new market letters—over 500 in 1983; (8) a surge in the number of secondary distributions (over 600 such stock sales last year, indicating "that somebody wants out"); (9) "the most pernicious and continuing corporate insider selling in history" (nine shares sold to every one bought); (10) a record margin debt ($22 billion), reflecting "superspeculation"; (11) very low mutual fund cash reserves; (12) merger and acquisition activity that is at or near the peak of its nine-year cycle; and (13) a record number of new money managers (about 8,000 of them, "mostly young, who don't remember 1929").

It's "Which Way Did They Go?" year for the Jews. After thousands of years of persecution and attempts at decimation and genocide, the world (at least the US) is beginning to worry about their disappearance. After all, it was four Jews who changed the thinking of the world, Christ, Marx, Einstein and Freud. The world may yet decide that it needs Jews. But although the Jews have survived all the slaughter, it now appears that acceptance and liberalism may herald the Jews' extinction.

In an article in the New York Times, the Los Angeles Times, and the Wall Street Journal, the story is told. Intermarriage, disinterest, a birth rate lower than their death rate and the desire by Jewish women to pursue careers rather than early motherhood is threatening to make Jews an endangered species by early in the 2000 Century (be kind to me, dear readers, I'm a human Dodo bird).

* *

I have just received the *Industry Forecast* by S. Jay and David Levy, Box 26, Chappaqua, NY 10514. The Levys are economists with a long record of being right. They are predicting a stagnant economy in late-1984, and a worst case inflation rate of 3%. On that basis they state, "Once the realities of the 1984 economy are recognized . . . . (interest) rates will fall to levels at or below the 1983 lows." How's that for a contrary opinion!

* *

I need a laugh every once in a while, and this one gave me a laugh. Danny Divoto tells the story of the Italian actor who was doing Shakespeare and doing it atrociously. Oranges, eggs, slices of salami hit the stage. The actor, looking flustered, shouted, "Hey wait a second, I didn't write this sh––!"

INTEREST RATES, BONDS: What's the toughest thing in the world? No, it's not a $.50 steak from Tijuana. It's trying to predict interest rates. Right now the overwhelming consensus is that rates are headed higher into the election and after. But the market (including the bond market) can do anything, and I note that the D-J 20 Bond Average (starting from the week ending February 3) has been lower on 11 out of 12 weeks! Now 91% declines over a 12 week period discounts a lot of bad news, and it seems to me that the bonds (all kinds of bonds) should be ready to rally. By far the best acting bonds in 1984 have been the higher-grade Munis, with California GOs now yielding 9.50 (they were 9.70 a few weeks ago). You've got to make 19% on your money if you're in the 50% bracket to beat these bonds, and brother, that's hard to do.

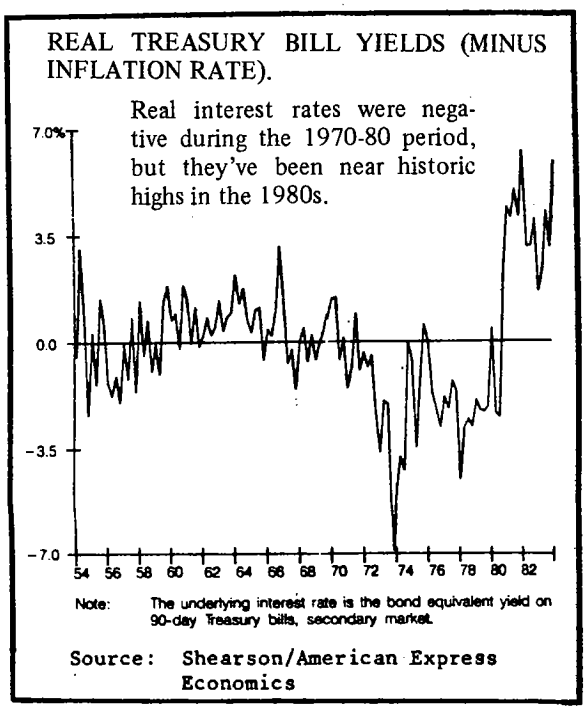
GOLD: Gold-philes are still waiting for a repeat of 1976-80 when gold rocketed into the stratosphere, finally topping out at a price of 850. But what produced fortunes for investors in 1980 is probably not fated to make fortunes for investors four years later. The markets seldom provide carbon copy performances–at least not when so many expect it.

One major difference in the situation during 1976-80 and today is illustrated in this chart. Here we see that Treasury bills during the gold boom years were providing a negative yield. In other words, after inflation was factored in, the investor actually lost money on T-bills (negative real interest). But the situation is vastly different today. Today the buyer of T-bills gets paid near 6% real interest for his investment. Under those conditions, the no-return feature of gold entails a real sacrifice, and the gold bullion buyer can only hope and wait for runaway inflation again.

On the point & figure chart (chart courtesy of Chartcraft, Larchmont, NY) we see the same story that has been in effect for months now. It will take a rise in spot gold to 408 to turn the picture even near-term bullish–and that hasn't happened yet. Which (I repeat) is strange in the view of the almost universal predictions of inflation, more inflation and hyper-inflation.

On the downside the critical number is 364. If gold breaks to 364, I would say the gold bear market was re-confirmed, in which case I would expect a testing of the 300 level. So there we have it–the gold story in two numbers, 408 on the upside and 364 on the downside. In the meantime, everyone needs income and holding gold costs one 9 to 13% in lost income. Therein lies the problem with the gold hedge.

By the way, I've said this before and I want to repeat it. The key word for the rest of this decade is going to be "income." In the land of deficits and high taxes we're all going to need a survival psychology–and income!


REAL TREASURY BILL YIELDS (MINUS INFLATION RATE).
Real interest rates were negative during the 1970-80 period, but they've been near historic highs in the 1980s.
7.0%
3.5
0.0
-3.5
-7.0
54 56 58 60 62 64 66 68 70 72 74 76 78 80 82
Note: The underlying interest rate is the bond equivalent yield on 90-day Treasury bills, secondary market.
Source: Shearson/American Express Economics

NEXT MAILING: May 16